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THE NEW ROLLOVER RULES AND TWENTY PERCENT WITHHOLDING TAX ON PENSION DISTRIBUTIONS: DOES GOOD PENSION POLICY FAVOR THEIR REPEAL?

LEANDRA LEDERMAN GASSENHEIMER*

INTRODUCTION

In July 1992, President George Bush signed into law the Unemployment Compensation Amendments (UCA) of 1992,¹ which included provisions substantially changing the treatment of many distributions from qualified plans² and section 403(b)³ tax sheltered annuities (TSAs). The provisions affecting qualified plans and TSAs generally became effective January 1, 1993,⁴ with a transition rule provided for certain TSAs that could delay the effective date of the provisions for such TSAs until January 1, 1994.⁵ The UCA expanded the types of distributions from such plans and annuities eligible for deferral of income tax by rollover⁶ to another qualified plan, TSA or individual re-

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1. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 42 U.S.C., & 45 U.S.C.).

2. See I.R.C. § 401(a) (1994) (requirements for qualified pension, profit-sharing and stock bonus plans).

3. Section 403(b) of the Internal Revenue Code provides a form of tax-exempt annuity for employees of tax-exempt organizations. I.R.C. § 403(b) (1994). Tax-exempt organizations are not eligible to sponsor 401(k) plans. I.R.C. § 401(k)(4)(B) (1994). A full discussion of the tax treatment of section 403(b) plans is beyond the scope of this article. Where appropriate, this article will indicate differences in the tax treatment of such plans and qualified plans, but any such discussion is not meant to be comprehensive.

4. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 521, 106 Stat. 290, 313 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.).

5. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 522, 106 Stat. 290, 315 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C., & 45 U.S.C.).

6. In general, a rollover is a transfer of assets from one retirement plan to another. See *infra* notes 50-51 and accompanying text.

tirement account (IRA).⁷ Among the changes made by the UCA⁸ is a new provision of the Internal Revenue Code (Code) of 1986, as amended, that requires plans to provide a "direct rollover option" in order to be tax-qualified.⁹ The price for the expansion of the rollover rules was an unprecedented twenty percent withholding tax on distributions that are eligible for "direct rollover" to another plan but that are rolled over in another fashion or are not rolled over at all.¹⁰

The new withholding tax and rollover rules have been complicated and confusing since their inception, requiring numerous administrative technical revisions and attempts at clarification.¹¹ This article analyzes the new rules in the context of the policies behind the tax treatment of pension plans. Part I of the article discusses these policies. Part II explains the current system of taxation of tax-qualified plans and IRAs and outlines the rollover rules prior to the UCA changes. Part III of the article discusses the changes to pension plan distributions imposed by the UCA, the regulations thereunder and the IRS releases interpreting the new law. Part IV criticizes the UCA changes and analyzes the problems with the new provisions governing pension plans. The article concludes that encouraging retirement savings is a valuable policy goal, and that the twenty percent withholding tax on pension plan distributions should be repealed because it does not further this goal. The

7. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, §§ 521-522, 106 Stat. 290, 300-315 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C., & 45 U.S.C.).

8. The UCA also imposes on plan administrators strict notice requirements designed to provide participants with information on the new rules. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 521(a), 106 Stat. 290, 309 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.); I.R.C. § 402(f) (1994).

9. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 522(a), 106 Stat. 290, 313 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.); I.R.C. § 401(a)(31) (1994).

10. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 522(b), 106 Stat. 290, 314 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.); I.R.C. § 3405(c) (1994).

11. See Warren G. Lamont, *How Will the Taxpayer Victory in Newark Morning Ledger Affect Pending Legislation?*, 78 J. TAX'N 322, 322 (June 1993) "The complex and technical mandatory 20% withholding/direct rollover provisions added to the Code by the Unemployment Compensation Amendments of 1992 continue to generate administrative attempts at clarification and relief." *Id.* In October 1992, the Treasury Department released Temporary and Proposed Regulations interpreting the UCA provisions affecting pension plans. 57 Fed. Reg. 48,163 (1992). In addition, the IRS has released numerous announcements and notices, in apparent attempts at clarification. See, e.g., Announcement 94-40, 1994-12 I.R.B. 7; Announcement 94-46, 1994-13 I.R.B. 22; Announcement 93-20, 1993-6 I.R.B. 65. Furthermore, commentators on the Proposed Regulations have pointed out other technical points and a loophole that should be addressed. See *infra* text accompanying notes 133-41.

article further concludes that the provision of a direct rollover option should not be a plan qualification requirement.

I. POLICIES BEHIND THE CURRENT SYSTEM OF TAXATION OF PENSION PLANS

Retirement is a social phenomenon that has gained importance as life expectancies have increased.¹² Under the present system, retirees live on some combination of Social Security or other government aid,¹³ private savings, employment income (particularly from part-time jobs), assistance from family or friends, and pensions.¹⁴ Although Social Security is mandatory,¹⁵ it does not provide a high level of replacement for pre-retirement income. Private pensions, and specifically employment-based pensions,¹⁶ are therefore a particularly important source of income for retirees.¹⁷ Thus, Congress has chosen to favor

12. See JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW, 2-4 (1990 & Supp. 1991) [hereinafter LANGBEIN & WOLK].

13. Other forms of government aid include welfare and SSI, for which the elderly is not the only eligible group.

14. LANGBEIN & WOLK, *supra* note 12, at 22-23; see also Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century in SEARCH FOR A NATIONAL RETIREMENT SECURITY POLICY* 159, 159 (J. VanDerhei ed. 1987) (noting the pervasive government influence on retirement income, because Social Security is the "backbone" of the retirement system in the United States, and, in addition, federal law highly regulates private pension plans).

15. See LANGBEIN & WOLK, *supra* note 12, at 24.

16. The United States private pension system is generally employer-based. See *id.* Individual retirement arrangements, which may serve as a vehicle for retirement savings, are an exception to this general rule. However, their use is severely restricted by a \$2,000 annual limit on deductible contributions, and other limitations. See *infra* text accompanying note 42. Employer-sponsored pension plans are either defined-contribution or defined-benefit.

[T]he term "defined contribution plan" means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to each participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

I.R.C. § 414(i) (1994); see also Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 3(34), 88 Stat. 829, 946 (ERISA) (benefits are based solely on the amount contributed to a participant's account). ERISA also refers to these plans as "individual account plans." *Id.* Amounts contributed to the plan on behalf of a participant may be allocated to an "account" of that participant. *Id.* (a defined contribution or individual account plan is one where benefits are based solely on the amount contributed to a participant's account). These amounts cannot be distributed to a participant for any reason other than separation from service, death, disability, attainment of age 59 1/2, hardship or termination of the plan. I.R.C. § 401(k)(2)(B), (k)(10) (1994).

A pension plan that is not a defined-contribution plan is a defined-benefit plan. I.R.C. § 414(j) (1994); ERISA § 3(35).

17. See LANGBEIN & WOLK, *supra* note 12, at 23, 24 (more retirees receive pension benefits than any other single source of income except Social Security; the employment-based nature of private pension is a key element of our retirement system); Cf. Hughes Proposes to Establish

certain types of pension plans¹⁸ with various tax incentives,¹⁹ designed to encourage retirement savings, within certain limitations.²⁰

Retirement plans are subject to two regulatory schemes that reflect different policies. The Employee Retirement Income Security Act (ERISA) of 1974, as amended, comprehensively addresses the goal of protecting workers' pensions,²¹ but generally does not provide incentives to employers to create pension plans for their employees.²² In contrast, if an employer-based pension plan meets certain highly technical requirements, it can become "tax-qualified," which has several advantages to the employer and the employee. First, an employer may deduct its contributions to a qualified plan, subject to a ceiling amount.²³ Second, the plan trust is exempt from tax, which allows tax-free growth of the funds in the trust.²⁴ Third, the employee is not taxed on his pension funds until he actually receives them.²⁵ Given these benefits to employees, an employer who sponsors a pension plan

Commission on Retirement Income Policy, *Pens. & Benefits Daily (BNA)* (Jan. 8, 1993) (Noting that only 46 percent of the full-time workforce is covered by a company-sponsored pension plan, Hughes said, "We are facing a ticking time bomb in the years ahead as more and more workers move through the workforce with little or no pensions, minimal savings, and few other means to support themselves during their retirement years.").

18. This article uses the term "pension plan" to refer to qualified plans and tax-sheltered annuities. This paper uses the term "retirement plan" to refer to both pension plans and IRAs.

19. See I.R.C. § 402(a) (1994) (deferring taxation of benefits until distribution to participant); I.R.C. § 404(a) (1994) (allowing deduction to employer who makes contributions to a qualified plan); I.R.C. § 501(a) (1994) (exempting the trust from tax). See also I.R.C. § 219 (1994) (allowing a deduction to an individual who makes "qualified retirement contributions" not in excess of \$2000, and subject to certain other limitations); I.R.C. § 401(a) (1994) (detailing the requirements of qualified pension, profit-sharing and stock bonus plans).

20. See I.R.C. § 501(a) (1994).

21. Pub. L. No. 93-406, § 2, 88 Stat. 829, 939 (1974). ERISA, a comprehensive federal statute, expresses as among its policies the protection of interstate commerce, the federal taxing power and the interests of participants in employee benefit plans and their beneficiaries, through regulation of these plans. *Id.* at § 2(b)-(c). ERISA implements this policy in part through reporting and disclosure requirements, as well as minimum vesting requirements, minimum funding standards and plan termination insurance. *Id.*

22. Arguably ERISA discourages employers from adopting pension plans because of the restrictions it imposes. If that is the case, and the premise that the government wishes to encourage retirement savings is accepted, ERISA must be viewed as the counterbalance to a previously unregulated market in which employers may have adopted pension plans but many employees never saw their benefits because of extremely long vesting schedules or plans that were revoked or amended to eliminate benefits. STAFF OF SENATE COMM. ON AGING, 98TH CONG., 2D SESS., *THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: THE FIRST DECADE* 2-3 (Comm. Print 1984) (prepared by Michael S. Gordon).

23. I.R.C. § 404(a) (1994).

24. I.R.C. § 501(a) (1994).

25. I.R.C. § 402(a) (1994).

theoretically has an advantage in attracting employees over an employer who does not.

Tax-qualified plans in effect create a preference for retirement savings over other kinds of savings. The primary reason for such a tax preference is to encourage people to provide for themselves during retirement.²⁶ Because retirement savings are tax-favored, Congress is necessarily concerned that retirement plans may be used for purposes other than retirement.²⁷ In particular, Congress may try to prevent retirement plans from being used as a vehicle for saving for pre-retirement consumption. In addition, because the tax preference should advance the goal of providing retirement income for all those who need it, Congress has sought to prevent the use of retirement plans as a means to provide retirement income or tax benefits for primarily the highly compensated, which presumably is the group of people most able to provide for its own retirement, or at least the group least likely to require government assistance.²⁸ The concept of the equitable distribution of retirement benefits may at times conflict with the other policies behind tax-qualified plans.²⁹

26. See, e.g., David J. Kautter, *Employee Benefits: Statutory Simplification*, 18 TAX MGMT. COMPENSATION PLAN. J. 51, 53 (Mar. 2, 1990) (adopting the premise that qualified plans are intended to provide retirement income to individuals); Halperin, *supra* note 14, at 160 "The special tax treatment [of certain retirement plans] seems designed to channel saving for retirement" *Id.*

27. There are both too early and too late rules governing distributions from qualified plans and IRAs. See I.R.C. § 72(t) (1994) (10% additional tax imposed on funds withdrawn from a qualified plan or IRA before age 59 1/2 and not rolled over); I.R.C. § 401(a)(9) (1994) (required minimum distributions to participants who have attained age 70 1/2). These rules operate together to penalize those who use their retirement savings before age 59 1/2, an age at which most workers have not yet retired, and to encourage those over age 70 1/2 to consume their prior savings, which limits the ability of plan participants to use qualified plans as estate planning devices. In addition, an excise tax is imposed on "excess distributions" from qualified plans. I.R.C. § 4980A (1994). "Excess distributions" generally are annual distributions aggregating in excess of the greater of \$112,500 (indexed for post-1986 inflation) or \$150,000. I.R.C. § 4980A(c)(1) (1994). However, certain distributions are not taken into account for the purpose of this rule. I.R.C. § 4980A(c)(2) (1994).

28. Many of the tax rules governing qualified plans are the so-called non-discrimination rules that require such plans to have a minimum level of participation among lower compensated employees if higher compensated employees participate in the plan. See, e.g., I.R.C. § 410(b) (1994) (coverage requirements); I.R.C. § 401(a)(3) (1994) (satisfaction of I.R.C. § 410 minimum participation standard is a qualification requirement); I.R.C. § 401(a)(4)-(5) (1994) (contributions or benefits of a qualified plan cannot discriminate in favor of the highly compensated). These rules tend to prevent plans from providing benefits to highly compensated employees that are substantially disproportionate to those for rank and file.

29. See, e.g., Kautter, *supra* note 26, at 52 (equity, in the form of nondiscrimination rules, must be balanced with simplicity).

Tax provisions that advance the goals discussed above by deferring or foregoing the collection of tax have a revenue cost that Congress must consider; this legitimate concern has led to certain ceilings on amounts that may be contributed to qualified plans.³⁰ In addition, the juxtaposition of the desire to provide tax incentives and benefits to pension plans with the concern for the tax cost and for potential abuses has created an increasingly complex body of law in the pension area.³¹ Thus, another important goal of pension legislation may be simplification.³²

In sum, a healthy pension policy requires a delicate balance of various considerations, including: (1) encouraging individuals to provide for their retirement; (2) preventing potential abuses; (3) simplicity; and (4) cost control. The remainder of this article adopts this policy framework as the measuring stick for the appropriateness of the changes to the rollover rules enacted in the UCA. In addition, the article examines whether the UCA pension provisions succeeded in their stated goals. Before analyzing the UCA changes and engaging in a policy analysis however, it is important to understand the pre-UCA treatment of distributions from qualified plans and IRAs, and rollovers between plans.

30. For defined contribution plans, the total of employer contributions, employee contributions (not including rollover contributions) and forfeitures may not exceed the lesser of \$30,000 (or, if greater, one fourth of the dollar limitation in effect for defined benefit plans) or twenty-five percent of the participant's annual compensation. I.R.C. § 415(c) (1994). In addition, the maximum amount an employee may defer annually under a cash or deferred arrangement (commonly known as a 401(k) plan) is \$7000, indexed annually for inflation. I.R.C. § 402(g)(1), (5) (1994).

For defined benefit plans, a participant's annual benefit may not exceed the lesser of \$90,000 or 100 percent of the participant's average annual compensation for the three years of highest compensation. I.R.C. § 415(b)(1) (1994). A defined benefit plan may provide for a cost of living adjustment that is not included in computing this limitation. I.R.C. § 415(k)(2) (1994). In addition, this limitation is reduced if the employee has participated in the defined benefit plan less than ten years. I.R.C. § 415(b)(5) (1994). However, if the total annual benefits a participant receives from a defined benefit plan does not exceed \$10,000 and the participant has never participated in a defined contribution plan sponsored by that employer, the benefits paid to that participant will be deemed not to exceed the limitation. I.R.C. § 415(b)(4) (1994). The Code contains a further limitation where the same employee participates in both a defined benefit and a defined contribution plan sponsored by the same employer. See I.R.C. § 415(e) (1994).

31. See Kautter, *supra* note 26, at 51 (taxation of employee benefits has become increasingly complicated over the past fifteen years).

32. See *id.* (taxation of employee benefits is so complicated that it requires an increasingly specialized group of people to advise on it, and even they are often unsure of the advice they give). The Kautter article consists of a series of proposals to simplify numerous specific areas of the Code which govern employee benefit plans. Each proposal is followed by a short explanation of current law, the rationale for the proposal and the reduction of complexity that would be achieved. See generally *id.*

II. THE PRE-UCA TAX TREATMENT OF DISTRIBUTIONS FROM QUALIFIED PLANS, DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT ACCOUNTS AND ROLLOVERS

A. QUALIFIED PLANS AND INDIVIDUAL RETIREMENT ACCOUNTS

Section 401(a) of the Code provides the general rules for qualified pension, profit-sharing and stock bonus plans.³³ These plans are all employer-sponsored.³⁴ Section 404(a) allows an employer to deduct contributions to qualified plans.³⁵ Section 501(a) provides that a trust holding contributions to an employee benefit plan is exempt from taxation.³⁶ Section 401(k) of the Code provides that a qualified plan may include a cash or deferred arrangement (CODA) if the CODA meets certain requirements.³⁷ A CODA allows an employee to elect whether to receive current compensation in cash, on which he will be taxed, or instead to receive deferred compensation, free of current taxation.

The Code also provides tax incentives for saving for retirement in a medium other than an employer-based pension plan. ERISA created IRAs³⁸ as a further incentive for individuals to save for their retirements;³⁹ section 408 of the Code provides for IRAs and exempts them from tax.⁴⁰ IRAs generally allow eligible individuals to obtain a deduction for amounts contributed and then pay tax on distributions from the IRA.⁴¹ The maximum deductible amount an individual may contribute to an IRA in any taxable year is the lesser of \$2000 or one hundred percent of compensation.⁴² To the extent that an individual or his spouse is an active participant in a qualified plan, TSA or certain other plans, the \$2000 limitation is reduced.⁴³ The \$2000 limitation is

33. I.R.C. § 401(a) (1994).

34. *Id.*

35. I.R.C. § 404(a) (1994).

36. I.R.C. § 501(a) (1994).

37. *See* I.R.C. § 401(k) (1994); I.R.C. § 410(b) (1994).

38. ERISA § 2002(a) (adding I.R.C. § 408 (1994)).

39. Nicholas P. Damico, *Rollover Opportunities and Withholding on Distributions Both Expanded by New Law*, 78 J. TAX'N 4, 4 (Jan. 1993).

40. I.R.C. § 408(a), (e) (1994). Section 7701(a)(37) defines the term "individual retirement plan" as an IRA described in section 408(a) or an individual retirement annuity described in section 408(b). I.R.C. § 7701(a)(37) (1994).

41. I.R.C. § 219 (1994); I.R.C. § 408(d) (1994).

42. I.R.C. § 219(b)(1) (1994).

43. The \$2000 limitation is reduced by \$2000 multiplied by a fraction, the numerator of which is the excess of the taxpayer's adjusted gross income (AGI) for the taxable year over the applicable dollar amount (\$40,000 for a taxpayer filing a joint return, zero for a married taxpayer filing separately and \$25,000 for all other taxpayers). The denominator of the fraction is

not reduced below \$200 until the limitation is reduced to zero,⁴⁴ which, for married individuals filing jointly, is when their adjusted gross income (AGI) is \$50,000, for a single taxpayer, is when his AGI is \$35,000, and for a married taxpayer filing separately, is when his AGI is \$10,000.⁴⁵

B. THE ROLLOVER RULES

Because the existing pension system is largely employer-based, Congress needed to address the treatment of vested account balances of people who terminate employment with a company prior to retirement. Prior to the UCA, an employee terminating service before retirement age had several options: (1) he could leave the money in the plan until he was ready to receive a distribution;⁴⁶ (2) he could request a trustee-to-trustee transfer of all or part of his account balance into the qualified plan of his next employer, if that plan accepted such contributions;⁴⁷ (3) he could withdraw all or part of his account balance and roll it over into an IRA;⁴⁸ or (4) he could withdraw all or part of the

\$10,000. I.R.C. § 219(g) (1994). Thus, the formula for determining the new limitation is:

$$\$2,000 - \left[(2,000) \times \frac{\text{Taxpayer AGI} - \text{applicable dollar amount}}{\$10,000} \right]$$

A limitation that is not a multiple of \$10 is rounded to the next lowest \$10. I.R.C. § 219(g)(2)(C) (1994).

Where the taxpayers are married individuals filing a joint return, if their AGI is \$50,000, the dollar limitation will be zero, computed as follows:

$$\$2,000 - \left[(2,000) \times \frac{(\$50,000 - \$40,000)}{\$10,000} \right] = \$2,000 - (\$2,000 \times 1) = 0$$

Where the taxpayer is single, if his AGI is \$35,000, the dollar limitation will be zero, computed as follows:

$$\$2,000 - \left[(2,000) \times \frac{(\$35,000 - \$25,000)}{\$10,000} \right] = \$2,000 - (\$2,000 \times 1) = 0$$

Where the taxpayer is a married individual filing separately, if his AGI is \$10,000, the dollar limitation will be zero, computed as follows:

$$\$2,000 - \left[(2,000) \times \frac{(\$10,000 - 0)}{\$10,000} \right] = \$2,000 - (\$2,000 \times 1) = 0$$

44. I.R.C. § 219(g)(2)(B) (1994).

45. H.R. CONF. REP. on Pub. L. No. 99-514, 100 Stat. 2095, 99th Cong., 2d Sess. 841 (1986), *reprinted in* 1986 U.S.C.A.N. 4075, 4089-91; *see supra* note 43.

46. I am assuming that his account balance is at least \$3,500 so that the plan may not force him to take a distribution against his will.

47. *See* Rev. Rul. 67-213, 1967-2 C.B. 149.

48. The IRA, a tax exempt vehicle for holding individual deductible contributions, also may accept rollover contributions; since IRAs were created, rollover contributions have been a specific exception to the \$2000 annual limit on contributions. *See* I.R.C. §§ 219, 408(a) (1994);

account balance and not roll it over. Under this last option, he would be taxed on the amount withdrawn, and, if he was under age 59 1/2, he generally would be required by law to pay an additional ten percent penalty.⁴⁹

Both rollovers and trustee-to-trustee transfers involve the transfer of the assets from one retirement plan to another, as opposed to the contribution to a retirement plan from other sources of funds.⁵⁰ The rollover rules encourage retirement savings by providing a tax incentive to leave money in a pension plan or IRA rather than consume it currently. Thus, liberalization of these rules should encourage retirement savings.

Prior to the UCA, the rollover rules were more restrictive for partial distributions from a pension plan than they were for total distributions. In general, a qualified total distribution from a qualified plan could be rolled over into an IRA or another qualified plan that accepted rollover contributions. Similarly, a qualified total distribution from a TSA could be rolled over into an IRA or TSA.⁵¹ A qualified distribution was one that was made on account of the employee's death or other separation from service, after the employee became permanently and totally disabled or after he attained age 59 1/2.⁵²

A partial distribution is any distribution other than a qualified total distribution.⁵³ To be eligible for rollover prior to the UCA amendments, a distribution had to be at least fifty percent of the balance to the credit of the employee, it could not be one of a series of periodic payments and it had to be paid on account of the employee's death or other separation from service or after the employee became permanently and totally disabled.⁵⁴ A partial distribution from a qualified plan or TSA could only be rolled over into an IRA.⁵⁵ As under present law, rollover of any portion of the amount distributed from an

Damico, *supra* note 39. The possibility of rolling the funds over into an IRA is an important one because many qualified plans do not accept rollover contributions, and a terminating employee may no longer desire to keep his retirement money with the company he is leaving.

49. I.R.C. § 72(i) (1994).

50. The term "rollover" is used generally in this article to include trustee-to-trustee transfers as well as rollovers to IRAs.

51. I.R.C. § 402(a)(5)(E)(iv) (1991) (prior to amendment by the UCA). A total distribution is a distribution of the full account of the participant, within one taxable year of the recipient. I.R.C. § 402(a)(5)(E)(i) (1991) (prior to amendment by the UCA).

52. I.R.C. § 402(e)(4)(A) (1991) (prior to amendment by the UCA).

53. I.R.C. § 402(a)(5)(E)(v) (1991) (prior to amendment by the UCA).

54. I.R.C. § 402(a)(5)(D)(i) (1991) (prior to amendment by the UCA).

55. I.R.C. § 402(a)(5)(C)(ii) (1991) (prior to amendment by the UCA).

IRA was permitted prior to the UCA.⁵⁶ In all cases, the rollover was required to be accomplished within sixty days of the distribution.

Under pre-UCA law, a nontaxable rollover from a qualified plan to an IRA was often accomplished by delivering a check to the employee, who had sixty days in which to deposit the check in the IRA. This method of transfer to an IRA was different from a transfer between qualified plans, which was only allowed if the terms of both plans permitted a "trustee to trustee transfer."⁵⁷

III. THE PROVISIONS OF THE UCA, ITS LEGISLATIVE HISTORY, AND THE RELEASES INTERPRETING IT

The UCA was introduced by Representative Dan Rostenkowski on May 26, 1992 and was signed by President Bush on July 3, 1992. The purposes of the UCA were: "To extend the emergency unemployment compensation program, to revise the trigger provisions contained in the extended unemployment compensation program, and for other purposes."⁵⁸ The pension provisions were included as revenue raisers.⁵⁹

The pension provisions were generally effective January 1, 1993, but section 523 of the UCA provides a one-year grace period for the plan amendments required by the changes enacted in the UCA; plans need not be amended until the first plan year beginning on or after January 1, 1994, as long as the plan amendment is retroactive and the plan is operated in accordance with the new rules beginning January 1, 1993.⁶⁰

In October 1992, the Treasury Department released Temporary and Proposed Regulations reflecting the changes made by the UCA.⁶¹ The text of the Temporary Regulations serves as the text of the Proposed Regulations.⁶² The Temporary Regulations became effective January 1,

56. However, under both present and pre-UCA law, rollover of funds required to be distributed because a plan participant has attained age 70 1/2 is never permitted. I.R.C. § 401(a)(9) (1994) (required minimum distributions); I.R.C. § 402(a)(5)(G) (1994) (rollover of required minimum distributions prohibited).

57. See Rev. Rul. 67-213, 1967-2 C.B. 149.

58. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.).

59. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 299 at Tit. V.

60. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 315 § 523.

61. T.D. 8443, 1992-2 C.B. 80.

62. *Id.*

1993. The Temporary Regulations, in question and answer format, are promulgated under sections 401(a)(31), 402(c), 402(f), 403(b) and 3405(c) of the Code. The Temporary Regulations were issued without prior notice under the Administrative Procedure Act.⁶³

A. THE ROLLOVER PROVISIONS OF THE UCA

In general, under the UCA, qualified plans must be amended to provide a "direct rollover option" for "eligible rollover distributions".⁶⁴ In contrast to prior law, described above, new section 402(c)(4) of the Code generally provides that any part of a taxable distribution from a qualified plan or TSA is an "eligible rollover distribution" unless the distribution is a required minimum distribution under section 401(a)(9)⁶⁵ or "is one of a series of substantially equal periodic payments (not less frequently than annually)"⁶⁶ made over the participant's life or life expectancy (or the joint lives or life expectancies of the participant and his or her spouse) or over "a specified period of 10 years or more."⁶⁷ Nonperiodic payments made before, with or after the periodic payments are not treated as periodic payments and are eligible for rollover treatment.⁶⁸ This eradicates the distinction under prior law between partial distributions and qualified total distributions.⁶⁹ In addition, a post-1992 distribution that is part of a series of

63. *Id.* The preamble to the Temporary Regulations states:

The provisions contained in this Treasury Decision are needed immediately to provide guidance to the public concerning the direct rollover and 20-percent income tax withholding provisions of UCA because these provisions apply to eligible rollover distributions made after December 31, 1992. Therefore, it is found impracticable and contrary to the public interest to issue this Treasury Decision with prior notice under section 553(b) of Title 5 of the United States Code.

Preamble to T.D. 8443, 1992-2 C.B. 80. See also 5 U.S.C. § 553 (1994).

64. I.R.C. § 401(a)(31) (1994). Each eligible rollover distribution must be reported on Form 1099-R. Temp. Treas. Reg. § 31.3405(c)-1T (Q&A 12) (1994). The IRS has amended Form 1099-R to accommodate the new rules. See Announcement 93-20, 1993-6 I.R.B. 65 (1993). The IRS also recently clarified the instructions on Form 1099-R for reporting § 401(a)(9) minimum distributions, Announcement 94-46, 1994-13 I.R.B. 22 (1994), and which codes are used to reflect a direct rollover to an IRA versus a direct rollover to a qualified plan. Announcement 94-40, 1994-12 I.R.B. 7 (1994). Eligible rollover distributions paid to IRAs must also be reported on Form 5498 as a rollover contribution to an IRA. Temp. Treas. Reg. § 31.3405(c)-1T (Q&A 13) (1994).

65. Where a series of distributions is made in one taxable year, some part of which is a minimum distribution required by section 401(a)(9) of the Code, only the portion that is not a required minimum distribution is an eligible rollover distribution. Temp. Treas. Reg. § 1.402(c)-2T (Q&A 3(b)(2)) (1994).

66. I.R.C. § 402(c)(4) (1994).

67. *Id.*

68. H.R. CONF. REP. NO. 5260, 102d Cong., 2d Sess. 5857 (1992); Temp. Treas. Reg. § 1.402(c)-2T (Q&A 6) (1994).

69. Section 521(a) of the UCA eliminated former sections 402(a)-(f) and replaced them

distributions that began prior to 1993 is an eligible rollover distribution.⁷⁰

Hardship distributions are eligible rollover distributions.⁷¹ In addition, when a participant terminates employment and part of his account balance is used to offset an outstanding loan, the offset amount is an "eligible rollover distribution" if it is otherwise eligible for direct rollover, whether or not the offset occurs after the participant has terminated employment.⁷² However, a plan will not fail to qualify under section 401(a)(31) merely because it does not provide a direct rollover option for these offset amounts.⁷³

Section 522(a) of the UCA enacts new Code section 401(a)(31), which imposes the requirement that qualified plans include an optional direct transfer of eligible rollover distributions.⁷⁴ The new provision accomplishes the following changes from prior law: (1) it imposes an additional plan qualification requirement; and (2) it allows the partici-

with new sections 402(a)-(f). Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318 § 521, 106 Stat. 290, 300 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.).

70. Temp. Treas. Reg. § 1.401(a)(31)-1T (Q&A 1(c)) (1994).

71. Temp. Treas. Reg. § 1.402(c)-2T (Q&A 4) (1994).

72. Temp. Treas. Reg. § 1.402(c)-2T (Q&A 8) (1994); I.R.S. Notice 93-3, 1993-1 C.B. 293.

73. Temp. Treas. Reg. § 1.402(c)-2T (Q&A 8) (1994); I.R.S. Notice 93-3, 1993-1 C.B. 293.

74. Section 522(a) provides as follows:

OPTIONAL DIRECT TRANSFER OF ELIGIBLE ROLLOVER DISTRIBUTIONS.—

(A) **IN GENERAL.**—A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that if the distributee of any eligible rollover distribution—

(i) elects to have such distribution paid directly to an eligible retirement plan, and

(ii) specifies the eligible retirement plan to which such distribution is to be paid (in such form and at such time as the plan administrator may prescribe), such distribution shall be made in the form of a direct trustee-to-trustee transfer to the eligible retirement plan so specified.

(B) **LIMITATION.**—Subparagraph (A) shall apply only to the extent that the eligible rollover distribution would be includible in gross income if not transferred as provided in subparagraph (A) (determined without regard to sections 402(c) and 403(a)(4)).

(C) **ELIGIBLE ROLLOVER DISTRIBUTION.**—For purposes of this paragraph, the term "eligible rollover distribution" has the meaning given such term by section 402(f)(2)(A).

(D) **ELIGIBLE RETIREMENT PLAN.**—For purposes of this paragraph, the term "eligible retirement plan" has the meaning given such term by section 402(c)(8)(B), except that a qualified trust shall be considered an eligible retirement plan only if it is a defined contribution plan, the terms of which permit the acceptance of rollover distributions.

I.R.C. § 401(a)(31) (1994).

pant to elect a direct transfer of "eligible rollover distributions" as long as the recipient plan accepts rollover contributions⁷⁵ and the distribution would be subject to tax were it not rolled over.⁷⁶ Section 522(c) of the UCA amends section 402(e), as already amended, and section 403(a), to provide that any amount transferred in a direct transfer in accordance with section 401(a)(31) is not includible in gross income for that year.⁷⁷ The Regulations provide that a plan can satisfy the requirement of section 401(a)(31) even if it does not offer a direct rollover option for distributions that are reasonably expected to total less than \$200 in a year.⁷⁸

The Regulations provide guidance on what constitutes a "direct rollover." In general, they provide that any reasonable means of direct payment to an eligible retirement plan⁷⁹ is acceptable,⁸⁰ including providing a distributee with a check that is payable to the trustee of the eligible plan, for the benefit of the participant with instructions to the employee as to where to deliver it.⁸¹

B. THE WITHHOLDING PROVISIONS OF THE UCA

Although an employee may elect to forego a direct rollover, section 522(b) of the UCA added new section 3405(c)⁸² to the Code,

75. A qualified plan is not required to accept direct transfers. Temp. Treas. Reg. § 1.401(a)(31)-1T (Q&A 13) (1994).

76. Section 522(c)(2) also provides for conforming amendments to other Code sections.

77. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318 § 522(c), 106 Stat. 290, 315 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.).

78. Temp. Treas. Reg. § 1.401(a)(31)-1T (Q&A 11) (1994).

79. "Eligible retirement plan" is defined as an individual retirement plan (an IRA or TSA) or a qualified plan. *Id.* at Q&A 2.

80. *Id.* at Q&A 3.

81. *Id.* at Q&A 4. The Preamble to the Regulations justifies this option:

The Service and the Treasury believe that allowing a direct rollover to be accomplished via the employee's delivery of a check will, in certain circumstances, simplify the administration of the direct rollover option and reduce the likelihood of errors. Moreover, because the check must be negotiable only by the trustee of the eligible retirement plan, the Service and the Treasury do not anticipate that allowing delivery by the employee will result in significant noncompliance.

Preamble to T.D. 8443, 1992-2 C.B. 80.

82. Section 3405(c) provides:

ELIGIBLE ROLLOVER DISTRIBUTIONS.—

(1) IN GENERAL.—In the case of any designated distribution which is an eligible rollover distribution—

(A) subsections (a) and (b) shall not apply, and

(B) the payor of such distribution shall withhold from such distribution an amount equal to 20 percent of such distribution.

(2) EXCEPTION.—Paragraph (1)(B) shall not apply to any distribution if the distributee elects under section 401(a)(31)(A) to have such distribution paid directly to

which imposes a mandatory twenty percent withholding tax on any such distribution that was eligible for direct rollover.⁸³ The employee may still roll the distribution over within 60 days and escape current taxation on the distribution, but the withholding tax will apply.⁸⁴ In a sense, the mandatory withholding tax is the price for the rollover option. In conjunction with the new rules, the UCA requires plan administrators to provide a written notice to plan participants explaining the rollover options and the withholding tax.⁸⁵

The fact that a hardship distribution is treated as an eligible rollover distribution,⁸⁶ means that the mandatory withholding tax applies unless the participant elects to roll the distribution directly to an IRA,⁸⁷ which is somewhat inconsistent with the notion of a pressing financial need for the money.⁸⁸ Section 3405(c) does not exempt hardship distributions, deemed distributions arising from overdue loans,⁸⁹

an eligible retirement plan.

(3) ELIGIBLE ROLLOVER DISTRIBUTION.—For purposes of this subsection, the term "eligible rollover distribution" has the meaning given such term by section 402(f)(2)(A) (or in the case of an annuity contract under section 403(b), a distribution described in section 402(f)(2)(A)).

I.R.C. § 3405(e) (1992). Section 522(b) of the UCA also provides for conforming amendments. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318 § 522(c), 106 Stat. 290, 315 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.).

83. See I.R.C. § 3405(c)-(e) (1992).

84. See *id.* The Preamble to the Regulations points out that the UCA amended section 3405 to impose mandatory 20-percent income tax withholding on any eligible rollover distribution that the employee does not elect to have paid in a direct rollover. "This withholding applies even if the employee receives a distribution and then rolls it over within the 60-day period." T.D. 8443, 1992-2 C.B. 80.

85. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318 § 521(a), 106 Stat. 290, 300 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C., 42 U.S.C. & 45 U.S.C.); I.R.C. § 402(f) (1994).

86. See *supra* text accompanying note 72.

87. Damico, *supra* note 39, at 5.

88. Cf. *id.* at 7 n.10. "It appears unlikely, however, that a distribution could be transferred to another qualified plan consistent with hardship status." *Id.*; see also Letter from Louise S. Stephenson, Member, Administrative Committee, Capitol Broadcasting Co., to Sen. Jesse Helms (Aug. 26, 1992) in 139 CONG. REC. S673-01 (daily ed. Jan. 26, 1993).

Another concern is the employee who wants to buy his own home and he's not terminating. Now he can access all his 401k money except its earnings if he documents the amount requested as the actual need. Under present law he wouldn't request federal tax withholding because he will have offsetting interest deductions at income tax filing time. He will only have the 10% penalty now imposed for early withdrawal. Under the new law this fellow is going to pay 20% up front and wait maybe as long as 16 months to get it back when he needs it now.

See also Damico, *supra* note 39, at 5 (the Revenue Bill of 1992 would have exempted hardship distributions from eligibility for rollover and the concomitant withholding tax).

89. Withholding on an offset amount that is an eligible rollover distribution is limited to the sum of the cash and the fair market value of the property received by the participant.

or even distributions to plan participants who are over age 59 1/2 or retired.

The Temporary Regulations provide that the plan administrator is responsible for the mandatory withholding, but may shift the responsibility to the payor by following certain procedures.⁹⁰ The plan administrator is entitled to reasonably rely on adequate information provided by the distributee.⁹¹ The Temporary Regulations clarify that distributions that are not eligible rollover distributions, and accordingly are not subject to the new twenty percent withholding, are subject to elective withholding, as under prior law.⁹² The Temporary Regulations also clarify that if a participant elects to have only a portion of a distribution transferred by direct rollover, the mandatory withholding applies only to the portion that is not so transferred.⁹³

There is no mandatory withholding on distributions of employer securities; where a distribution consists solely of employer securities and cash in lieu of fractional shares not in excess of \$200, no withholding is required.⁹⁴ Where cash in excess of \$200 or other property is distributed in addition to the employer securities, the amount withheld cannot exceed the sum of the cash and the fair market value of the other property.⁹⁵

C. THE NOTICE REQUIREMENT

In conjunction with the new rollover rules discussed above, new section 402(f) of the Code creates a notice requirement:

WRITTEN EXPLANATION TO RECIPIENTS OF DISTRIBUTIONS ELIGIBLE FOR ROLLOVER TREATMENT.—

(1) **IN GENERAL.**—The plan administrator of any plan shall, *within a reasonable period of time before making an eligible rollover distribution* from an eligible retirement plan, provide a written explanation to the recipient⁹⁶

90. Temp. Treas. Reg. § 31.3405(c)-1T (Q&A 2-3) (1994).

91. *Id.* at Q&A 6.

92. *Id.* at Q&A 1.

93. *Id.* at Q&A 5.

94. *Id.* at Q&A 9.

95. *Id.*

96. I.R.C. § 402(f) (1992) (emphasis added). New subsection (d) of section 402 provides a special method for computing tax on lump sum distributions. I.R.C. § 402(d) (1992). New subsection (e) provides various rules applicable to special cases, such as alternate payees under qualified domestic relations orders, distributions by the United States to nonresident aliens, and CODAs. I.R.C. § 402(e) (1992).

This section requires plan administrators to inform plan participants of their rights and options under the new rules, as well as the withholding tax that may apply.⁹⁷ Only if, after receiving the notice, the distributee affirmatively elects to make or forego a direct rollover may the distribution be made immediately.⁹⁸

The Regulations provide that "reasonable time" for purposes of the new notice requirement under section 402(f) means no earlier than 90 days before and no later than 30 days before the distribution is made, in cases where the plan administrator is not required to provide a general description of the distributee's rights and options under the plan.⁹⁹ In a case where the plan administrator is required to give such a description, the "reasonable time" requirement is satisfied only if the plan administrator provides the section 402(f) notice within the same time limits imposed on the general description of rights.¹⁰⁰ For a series of payments that are eligible rollover distributions, the plan administrator must provide the notice prior to the first payment, in accordance with the time constraints discussed above, and then provide the notice at least once annually for the duration of the payments.¹⁰¹

97. Section 521(d) of the UCA requires the Secretary of the Treasury or his delegate to promulgate a model explanation that meets the requirements of new section 402(f). Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318 § 521(d), 106 Stat. 290, 313 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.). On October 20, 1992, the IRS released Notice 92-48, which does so. I.R.S. Notice 92-48, 1992-2 C.B. 377.

98. Temp. Treas. Reg. § 1.402(c)-2T (Q&A 13) (1994).

99. *Id.*

100. *Id.* at Q&A 12.

101. *Id.* at Q&A 14.

The "Summary" portion of the safe harbor explanation provides as follows:

If you choose a DIRECT ROLLOVER

▸ Your payment will not be taxed in the current year and no income tax will be withheld.

▸ Your payment will be made directly to your IRA or, if you choose, to another employer plan that accepts your rollover.

▸ Your payment will be taxed later when you take it out of the IRA or the employer plan.

If you choose to have your Plan benefits PAID TO YOU

▸ You will receive only 80% of the payment, because the plan administrator is required to withhold 20% of the payment and send it to the IRS as income tax withholding to be credited against your taxes.

▸ Your payment will be taxed in the current year unless you roll it over. You may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59 1/2, you also may have to pay an additional 10% tax.

▸ You can roll over the payment by paying it to your IRA or to another employer plan that accepts your rollover within 60 days of receiving payment. The amount rolled over will not be taxed until you take it out of your IRA or employer plan.

Many commentators noted that the thirty day/ninety day notice rule is inflexible and might be difficult to administer.¹⁰² Initially, the rule was problematic because notice could not be waived.¹⁰³ In Notice 93-26, 1993-18 I.R.B. 11, the IRS announced that employees can waive the 30 day notice requirement, as long as they are informed of their right to the 30-day period. However, the plan must reflect the employee's right to do so, which generally will require plan sponsors to amend their plans.¹⁰⁴

IV. POLICY PROBLEMS WITH THE UCA PENSION PROVISIONS

From a policy perspective, there are three questions: (1) What are the policy justifications of the UCA pension provisions; (2) do the UCA pension provisions operate in a manner consistent with these justifications; and (3) do the UCA pension provisions operate in accordance with general pension policy? As discussed above, this paper adopts the premise that fostering retirement savings, within the limitations of cost and equity, should be the goal of the UCA pension provisions, or, indeed any law that regulates pensions. This Section of the

► If you want to roll over 100% of the payment to an IRA or an employer plan, YOU MUST FIND OTHER MONEY TO REPLACE THE 20% THAT WAS WITHHELD. If you roll over only the 80% that you received, you will be taxed on the 20% that was withheld and that is not rolled over.

I.R.S. Notice 92-48, 1992-5 I.R.B. 25. The text of the rest of the notice is several more pages and includes examples of how the withholding rules apply. *Id.*

102. See, e.g., Letter from Michael P. Sjogren, Seward & Kissel, on behalf of Merrill, Lynch, Pierce, Fenner & Smith, Inc. to John Tolleris, I.R.S. (Jan. 12, 1993) available in LEXIS, Fedtax library, TNT file; Letter from Stanley C. Simon, Winn, Beaudry & Winn, LLP to I.R.S. (Oct. 28, 1992) available in LEXIS, Fedtax library, TNT file; Letter from Scott Bergeson, American Stores Co. to I.R.S. (Jan. 21, 1993) available in LEXIS, Fedtax library, TNT file.

103. The problem with the lack of a waiver option was particularly evident in the area of hardship distributions. CODAs are permitted to allow distributions for certain financial needs, including medical expenses, tuition, purchase of a principal residence, funeral expenses and the like. Treas. Reg. § 1.401(k)-1(d)(2)(iv) (1994). One writer remarked:

[a] payee who is applying for a distribution should be permitted to waive the 30-day minimum notice requirement. This is particularly important for hardship distributions (both of section 401(k) deferrals and of other amounts). The desirability of the waiver is illustrated by this scenario involving a plan that does not permit loans:

Participant: "I need a distribution immediately. My wife just died, and the funeral home insists on payment in advance."

Plan administrator: "Read this notice, put her in the deep freeze, and come back in 30 days for your money."

Letter from Stanley C. Simon, Winn, Beaudry & Winn, LLP to I.R.S. 1 (Oct. 28, 1992) available in LEXIS, Fedtax library, TNT file.

104. The IRS issued model language that plan sponsors can use to make such an amendment. Rev. Proc. 93-47, 1993-2 C.B. 578.

paper analyzes whether the UCA pension provisions accord with these policies or are successful in furthering any of their stated goals.

A. STATED POLICIES

The legislative history of the pension provisions of the UCA is brief. The Senate Committee Report on the UCA cites flexibility and encouraging retirement savings as the reasons for liberalizing the rollover rules.¹⁰⁵ The Report states that a direct transfer option will decrease early cashouts, and justifies the withholding as enabling those taxpayers who do not roll over the funds to satisfy their tax obligations:

A significant source of lost pension benefits is preretirement cashouts of pension savings in lump-sum distributions. The bill facilitates the preservation of retirement benefits for retirement purposes by requiring plans to transfer eligible rollover distributions directly to an IRA or another qualified plan. Withholding ensures that taxpayers will be able to satisfy their tax liabilities.¹⁰⁶

1. Encouraging Retirement Savings

Encouraging pension portability is a stated purpose of the UCA,¹⁰⁷ which should mean fostering retirement savings. In general, the UCA pension provisions expand the types of distributions from qualified plans and TSAs that are eligible for rollover, which, in a vacuum, should allow more plan participants to defer consumption of their pension funds until retirement. However, a recent study by Hewitt Associates revealed that employees elect a direct rollover of all or part of their final distribution from a pension plan less than one-quarter of the time, despite the mandatory withholding tax.¹⁰⁸

105. The Report stated

[t]he complexity of the present-law rollover rules create needless problems for individual taxpayers. For example, the restrictions on rollovers lead to inadvertent failures to satisfy the rollover requirements. Liberalization of the rollover rules will increase the flexibility of taxpayers in determining the time of the income inclusion of pension distributions and will encourage taxpayers to use pension distributions to provide retirement income.

S. REP. NO. 85, 102d Cong., 2d Sess. S8180 (1992) (Senate Report on the UCA). It has been stated that there were two goals behind the pension provisions in the UCA: increasing pension portability by loosening the rollover rules and "prevent[ing] any revenue loss resulting from plan distributions that are not rolled over." Congress Rolls Out New Rules for Rollovers, 79 *Stand. Fed. Tax Rep. (CCH), Tax Focus*, Part II, no. 45 at 1 (Sept. 16, 1992).

106. S. REP. NO. 85, 102d Cong., 2d Sess. S8180 (1992) (Senate Report on the UCA). The Conference Report does not provide any further clarification on these provisions.

107. See *supra* note 105 and accompanying text.

108. Meegan M. Reilly, *Direct Rollovers from CODAs May be Unexpectedly Infrequent*,

If fostering retirement savings was a purpose of the UCA, one wonders why the liberalization of the rollover provisions was accompanied by a mandatory withholding tax, particularly one that applies even if the participant is not subject to the ten percent penalty for early distributions.¹⁰⁹ In addition, the combination of a new plan qualification requirement, new notice requirement, the administrative costs of amending plans and administering them differently, and the fiduciary responsibility and administrative costs of mandatory withholding may in fact discourage some employers from maintaining or establishing pension plans.¹¹⁰

Although liberalization of the rollover rules appears to foster retirement savings and is an ostensible reason behind the change in law, in fact, the UCA provisions did not have entirely this purpose or effect. Many commentators have pointed out that there are better ways to encourage retirement savings,¹¹¹ and that liberalization of the rollover rules need not be accompanied by a withholding tax.¹¹²

Survey Finds, 62 TAX NOTES 83 (1994).

109. The UCA does not make any provision for exempting participants over age 59 1/2 from the withholding tax. See Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 42 U.S.C. & 45 U.S.C.). See also Letter from George S. Nugent, First of America Bank Corp. (Jan. 15, 1993) available in LEXIS, Fedtax library, TNT file (recommending that the withholding requirement be waived for distributions to participants over age 59 1/2).

[I]f the primary objective of the new distribution rules is to increase plan portability, there is minimal benefit to participants over age 59 1/2 who will most likely NOT become participants in other qualified plans. These individuals are usually receiving distributions because they are retired and using the funds to support themselves.

Id.

110. "Sheila Jamison of Dean Witter's Retirement Plan Service Department reports that several small and mid-sized firms are considering abolishing their pension plans rather than take on the fiduciary liability and administrative costs involved." 139 CONG. REC. S673-01, S676 (daily ed. Jan. 26, 1993) (remarks of Sen. Jesse Helms). "[T]he complex law could cause smaller firms to drop their pension plans to avoid the new fiduciary liability and costs involved." Elizabeth M. MacDonald, *How to Beat the 20% Withholding Trap*, MONEY, Feb. 1993, at 62. See also Louise Kertesz, 401(k) Plan Sponsors Adjusting to Withholding Tax; Compliance Not as Difficult as Expected, BUS. INS., Sept. 6, 1993, at 3.

The new liability and costs derive from the fact that prior to the UCA, plan administrators generally did not withhold on pension plan distributions. There are administrative costs in establishing a system for doing so and in completing the required paperwork each time. A new type of fiduciary liability attaches to the plan administrator because he is now a withholding agent for the federal government.

111. See, e.g., Frank Lalli & Elizabeth M. MacDonald, *Let's Repeal This Lousy Tax Law*, MONEY, Dec. 1992, at 7 [hereinafter Lalli]. The article states, "[i]f the lawmakers' true intent was to preserve pension savings, why didn't they simply require pension plans to roll all early distributions into IRAs? Fact is, that clearheaded solution was proposed — and rejected. Why? Because it wouldn't raise any tax revenue. This withholding nightmare materialized in its place." *Id.*

112. See, e.g., Damico, *supra* note 39, at 5; Lalli, *supra* note 111, at 7.

The addition of a new plan qualification requirement is also troublesome from a policy perspective. It requires amending all qualified plans, which is costly. Unless the plan sponsor adopts a safe harbor amendment to the plan, the new plan qualification requirement will force the plan sponsor to seek a new determination letter, which is even more costly and time-consuming. There is also the risk that a plan administrator will fail to comply with the new rules, thus subjecting the plan to potential disqualification. In such case, the plan participants would be subject to tax on their retirement savings. This certainly does not foster retirement savings, and although it may raise revenue, the UCA certainly did not intend to raise revenue in this way.

2. Revenue

The pension provisions are included in the "Revenue Provisions" of the UCA.¹¹³ The cost of the extension of unemployment benefits was financed in part by withholding on pension plan distributions that are eligible for rollover.¹¹⁴ This raises an inherent conflict: To the extent the pension provisions encourage people to keep their retirement savings in retirement solution, the government raises no revenue. It is only to the extent that employees cash out of their plans that the government raises revenue.¹¹⁵

Although it makes a certain amount of sense to fund a one-time extension of unemployment benefits with a withholding tax (which generally has a one-time effect of accelerating revenue collection),¹¹⁶ it is important to examine the amount of revenue the changes in law will raise. A senator who introduced legislation in 1993 to repeal the withholding tax stated that the UCA would not raise nearly the revenue

113. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 299 at Tit. V.

114. William L. Sollee & Paul J. Schneider, *New Law Changes Retirement Distribution Rules*, 77 J. TAX'N 171 (Sept. 1992).

115. One commentator sarcastically states, "Lawmakers were looking for ways to encourage workers who got payouts when they changed jobs to roll over the money into IRAs. The withholding idea hadn't been considered but, golly, the threat of withholding should encourage rollovers. And raise money. It was like manna from heaven." Kevin McCormally, *How a Dumb Idea Became Law*, 47 KIPLINGER'S PERSONAL FINANCE MAGAZINE, July 1993, at 44.

116. See *infra* note 119 and accompanying text.

anticipated.¹¹⁷ This has been supported by other commentators as well.¹¹⁸

Distributions that are eligible for direct rollover that are not rolled over at all are perhaps the most justifiable and largest source of revenue under the UCA provisions. These are distributions that are subject to current inclusion in the employee's gross income regardless of the UCA. Thus, the twenty percent withholding gives the government solely a timing benefit. This timing advantage may be mitigated by employees who decrease their wage withholding rather than waiting for a refund.¹¹⁹ In addition, although the government has a legitimate interest in collecting, at some point, the tax owed on distributions that are

117. 139 CONG. REC. S673-01 (daily ed. Jan. 26, 1993) (remarks of Sen. Helms). Sen. Helms stated:

Mr. President, the ill-conceived withholding provision was enacted as a means of financing the extension of unemployment insurance benefits provided for in Public Law 102-318. The bottom line, though is that these Tax Code changes will adversely impact retirees and other hardworking Americans while failing to raise the \$2.1 billion for the U.S. Treasury originally predicted by its Joint Tax Committee.

Id.

118. Representative Archer apparently called the tax's money-raising power "nothing more than an accounting gimmick." McCormally, *supra* note 115, at 44. See also Letter from Louise S. Stephenson, *supra* note 88 (remarks of Sen. Helms). She wrote:

These funds are not a new source of tax revenue. The government always gets its share whether it is from the distribution itself, income tax paid the next year, IRA wind-down, or through minimum distributions. The new tax grab puts it up front, it is arbitrary in its amount, and, in my opinion, will generate a large increase in IRS refunds the following year. I wonder if this expense was taken into account when the revenue potential was projected? Was the cost of setting up the Washington machinery to administer it deducted from expected returns? Based on my discussion with Finance Committee staff, just about everything in the bill as presently written has to be "fixed" before any of it will work.

Id. Senator Helms presented further data on the question:

David Langer, a consulting actuary in New York, calculated that \$2.143 billion in additional tax revenues would require \$10.7 billion in IRA distributions subject to the 20-percent withholding. As Mr. Langer points out, this is on the high side. Some people will no doubt figure out that the withholding can be avoided Mr. Langer estimates that instead of raising the estimated \$2.143 billion, the provision will actually only raise \$86 million David Langer estimates that the cost to businesses of implementing these changes will amount to more than \$4 billion over 5 years.

139 CONG. REC. S673-74 (daily ed. Jan. 26, 1993) (remarks of Sen. Helms).

119. Cf. MacDonald, *supra* note 110, at 62 "[Taxpayers may] recapture the money slowly by adjusting the withholding on their paychecks." *Id.*

not rolled over,¹²⁰ the twenty percent withholding figure is arbitrary at best.¹²¹

Under the UCA, the government also potentially receives revenue on distributions that are eligible for direct rollover that are rolled over by the employee via a sixty-day rollover, the same method allowed under pre-UCA law. Where 100% of the funds are in fact rolled over in a sixty-day rollover, the government will be receiving money to which it is not entitled and will have to refund.¹²² For example, where an employee rolls over one hundred percent of a distribution within sixty days, he does not owe any income tax on that distribution. This requires the employee to find other sources of money to replace the twenty percent that was withheld. This may mean that the government foregoes tax on the interest that money would have earned were it left in a regular savings account. The withholding therefore gives the government the use of money to which it is not otherwise entitled at the price of some lost tax on interest that would have been earned on that money. Where the employee rolls over within sixty days only the eighty percent that was actually distributed to him, which may happen where the employee does not have another source of funds to replace the amount withheld, the twenty percent that was withheld is treated as a taxable distribution.¹²³ In this case, the government not only has the use of the withholding, not all of which it is entitled to,¹²⁴ but also

120. *But see* Letter from Louise S. Stephenson, *supra* note 88 (remarks of Sen. Helms). She wrote:

There seems to have been some problems with retirees taking all their proceeds and not paying income tax — "forgetting" or some such. (God knows there are enough safeguards already in place to deal with this. Every cent is reported to the IRS through estimated tax reports, W-2Ps, etc., to alert them to the existence of a tax liability.) and 20% was selected "because it is somewhere between 15% and 31%, the minimum and maximum tax rates." . . . The new tax grab . . . is arbitrary in its amount

Id.

121. It is possible in this scenario that the amount of tax that the employee will owe is less than twenty percent of the distribution, depending on his other income and deductions. This is unlikely to be the case (although still possible) if the employee is under age 59 1/2, because he will owe the additional ten percent penalty on the early distribution, as well as income tax on the distribution. However, if the employee is over age 59 1/2, he will not owe the ten percent penalty, but will still be liable for the twenty percent withholding under the UCA. The government is required to refund any amounts that were overwithheld. Arguably this gives the government more than a mere timing advantage, as it had the use of money to which it was not otherwise entitled. However, this reveals the arbitrary nature of the twenty percent rate of withholding, and the unfairness of withholding on distributions to plan participants who have reached age 59 1/2 and are entitled to their money.

122. *See* Letter from Louise S. Stephenson, *supra* note 88 (remarks of Sen. Helms).

123. In this respect, the UCA discourages retirement savings because it refuses to allow rollover of the twenty percent withheld from an eligible rollover distribution, where the employee did not have an independent source of funds in that amount.

124. For example, assume an employee receives a \$10,000 distribution from a qualified plan

receives income tax and possibly a ten percent penalty¹²⁵ on the twenty percent withheld, but at the expense of decreasing the retirement savings of that employee.

If revenue is the justification for the UCA changes in the pension rules, then these changes cannot be said to foster saving for retirement, since revenue depends on premature distributions. If the liberalization of the rollover rules is expected to encourage people to roll over distributions rather than retain them for current consumption, the UCA provisions would not raise revenue and in fact would actually decrease current revenue. Thus, neither fostering retirement savings nor revenue is a convincing justification for the UCA provisions.¹²⁶

3. Other Rationales

Aside from encouraging individuals to provide for their retirement and revenue concerns, discussed above, theoretically the UCA provisions could advance the goals of simplicity or prevention of abuses of the retirement system. These goals are discussed in turn below.

that is eligible for direct rollover, but the employee does not elect the direct rollover option. \$2000 is withheld from the distribution, and the employee, who does not have \$2000 to spare, only rolls over \$8000 into an IRA within sixty days of the distribution. This \$2000 is now subject to tax as a distribution from a retirement plan that was not rolled over. Assuming income from other sources such that the employee is taxed on this income at a marginal rate at 28%, and assuming he has attained age 59 1/2, he owes the Federal government \$560 (twenty-eight percent of \$2000) on the distribution. If he has not attained age 59 1/2, he owes \$760 (ten percent of \$2000 plus \$560 in Federal income tax). In either case, the government withheld an excessive amount (\$2000). In addition, in either case, the government has reduced the employee's retirement savings by \$2000 and reduced his total savings by \$560 or \$760, as well as the time value of the \$2000.

125. This depends on whether the plan participant has attained age 59 1/2.

126. The only convincing explanation that would accept both justifications is that a relatively fixed percentage of people who take distributions from pension plans do not roll them over, and the twenty percent withholding tax on these distributions will help protect the revenue without altering people's behavior. For this to be true, several assumptions must be correct: (1) the administrative and fiduciary burdens resulting from the new law will not significantly decrease the number of employer-sponsored pension plans; (2) the number of people who become subject to the tax through inadvertent failure to elect the direct rollover but do in fact roll over the funds is at most negligible; (3) those people who do become subject to the tax by mistake can make up the twenty percent withheld from other sources; (4) those who are legitimately subject to the tax will not avoid it by electing a direct transfer to an IRA and then revoking the IRA; (5) people considering receiving a distribution from a plan will not wait to see if the withholding tax is repealed or modified; and (6) the IRS administrative costs of refunding tax withheld in cases where the actual tax liability was less than twenty percent of the amount distributed will not substantially offset the timing advantage of the withholding. Even if all of these assumptions are correct, the new rules are unlikely to raise the revenue needed to fund the unemployment extension. In addition, it is not clear why the tax should apply to hardship distributions and plan loans.

At least one commentator has noted that in the years after the passage of ERISA, a well-considered and comprehensive statute, amendments to employee benefits laws have often been accomplished as part of other bills.¹²⁷ Often, a motivating factor for a change in the employee benefits area is raising or protecting the revenue.¹²⁸ As a result, the taxation of employee pension benefits becomes increasingly complex, year after year,¹²⁹ and the changes in the laws may be harder to justify based on the traditional policies behind employer-based pension plans. This criticism certainly applies to the UCA. The UCA was signed by President Bush amid pressure to sign some unemployment bill; he had already vetoed two other bills that would have extended unemployment benefits.¹³⁰ The issue was politically important, but the question was what would finance an extension of benefits. Bush indicated that he would sign a bill if Congress could raise the money, and the pension provisions in the UCA were accepted as the way to do that.¹³¹

Commentators have pointed out various problems with the UCA provisions. For example, a representative of the American Institute of Certified Public Accountants submitted a long list of proposed chang-

127. See Kautter, *supra* note 26, at 51, 52 (referring to the "incremental overload" resulting from the layering of changes in the employee benefits area without integrating them into the existing scheme and praising the thoroughness of the activity preceding the enactment of ERISA).

128. *Id.*

129. See Lalli *supra* note 111, at 7.

130. See Lalli *supra* note 111, at 7. This article was printed in the Record of the Bill sponsored by Senator Helms to repeal the withholding tax. See 139 CONG. REC. S673-01, S676 (daily ed. Jan. 26, 1993).

131. See Lalli, *supra* note 111, at 7. The Money Magazine article strongly expresses the viewpoint that in an effort to find quick funding for the unemployment provisions, little thought was given to the best way to raise the money to pay for it:

Ever wonder how a dreadful idea becomes law? The story behind the government's new 20% withholding tax on early pension payouts is a classic. You can call it gridlock in action After twice vetoing billion dollar unemployment insurance extensions, President Bush signaled in July that he would go along if Congress could raise the money somehow. "The search was on to find revenue proposals," says a Senate Finance Committee staffer. "This is the one everyone agreed to." This bill swept to passage. "There's no record of any debate," says the staffer. "No one had to give position papers on it, since the entire process had to be hurriedly finished by the July 4th break." Or to put it another way: Gridlock + Haste = a Lousy Law.

Id. Money Magazine apparently received 500 letters in response to this inflammatory article. MacDonald, *supra* note 110, at 62.

A similarly inflammatory article states:

In a rush to start Fourth of July vacations, the House and Senate met on July 2, to consider the final version of the unemployment bill, including the withholding provision. "As far as I can find out, there was never the slightest discussion of it, really" reports [Henry] Von Wodtke [director of research for Buck Consultants]. "All of a sudden, whoops, there it was."

McCormally, *supra* note 115, at 44.

Certified Public Accountants submitted a long list of proposed changes.¹³² In addition, one commentator suggested that disability payments should not be subject to the withholding tax.¹³³ The same commentator requested clarification whether the twenty percent rate of withholding would be reduced in the case of a distributee who is a nonresident alien eligible to benefit from an income tax treaty between the United States and another country.¹³⁴ Similarly, a commentator has requested that the final regulations exempt residents of Puerto Rico from the withholding tax since many would not owe any federal tax or have to file a federal tax return, provided all of their income is sourced in Puerto Rico.¹³⁵

A technical revision in the UCA provisions may be needed to close a loophole. Treasury Regulations require banks to allow a depositor seven days to revoke an IRA.¹³⁶ In order to avoid withholding, a plan participant could elect a direct rollover to an IRA, revoke the IRA and retain one hundred percent of the money.¹³⁷ Of course, the depositor must roll the funds over to another IRA within sixty days to avoid applicable taxes and penalties.¹³⁸ Banks are prohibited from charging any fees in this circumstance.¹³⁹ One Commentator calls this "the IRA two-step".¹⁴⁰ A bank spokesperson commented that this aspect of the UCA rules may lead to abuses that will burden banks.¹⁴¹

In addition to commentators' concerns, at least five bills that would repeal the tax were proposed in Congress in 1993.¹⁴² Further-

132. *AICPA Comments on Rollover and Withholding Regulations*, Dec. 30, 1992, available in LEXIS, Fedtax library, TNT file.

133. *University Retirement Plan Proposes Changes in Withholding Regs.*, Jan. 4, 1993, available in LEXIS, Fedtax library, TNT file.

134. *Id.*

135. Tcherine Andujar, *Rollovers to Puerto Rico Residents Should Not be Subject to New Withholding Rules*, Jan. 21, 1993, available in LEXIS, Fedtax library, TNT file.

136. Treas. Reg. § 1.406-6(d)(ii)(A)(2) (1994).

137. Letter from George S. Nugent, *supra* note 109.

138. See MacDonald, *supra* note 110, at 63.

139. *Id.*

140. Kertesz, *supra* note 110, at 3.

141. Letter from George S. Nugent, *supra* note 109.

142. See A Bill to Repeal the Mandatory 20 Percent Income Tax Withholding on Eligible Rollover Distributions Which are Not Rolled Over, H.R. 2568, 103d Cong., 1st Sess. (1993) (sponsored by Rep. Franks); Income Tax Rollover Act of 1993, S. 501, 103rd Cong., 1st Sess. (1993) (sponsored by Sen. Barbara Mikulski); Repeal of mandatory 20 percent income tax withholding on eligible IRA distributions which are not rolled over, S. 190, 103d Cong., 1st Sess. (1993) (sponsored by Sen. Jesse Helms) (also introduced as S. 195); A Bill to repeal the mandatory 20 percent income tax withholding on eligible rollover distributions which are not rolled over, H.R. 503, 103d Cong., 1st Sess. (1993) (sponsored by Rep. George Darden); A Bill to repeal the provisions of the Unemployment Compensation Amendments of 1992 which provide for optional trustee-to-trustee transfers of eligible rollover distributions and im-

more, The National Employee Benefits Institute supports total repeal of the withholding rules.¹⁴³ Thus, the UCA provisions certainly did not foster the goal of pension simplification.

Prevention of abuses was not cited as a rationale for the UCA provisions. If the IRS had experienced difficulty collecting the tax due on early pension cashouts, that might be a legitimate justification for a withholding tax.¹⁴⁴ Similarly, if IRS experience demonstrated that taxpayers were manipulating the estimated tax provisions to achieve maximum deferral of the tax owed on pension distributions, that too might justify some amount of withholding. None of these justifications for the tax appear in the legislative history, and in addition, it is not clear that a twenty percent withholding tax is an appropriate way to achieve these goals.¹⁴⁵

CONCLUSION

The protection and fostering of retirement savings for a widespread section of the population is a legitimate tax policy. Liberalization of the rollover rules advances this policy by fostering savings in retirement plans that penalize early consumption of the money. Such liberalization generally has a revenue cost since individuals that roll over funds rather than consume them are deferring payment of tax on that money.

Although raising revenue is also a legitimate goal of the Federal government, it is not appropriate for the revenue to come from a source that should be protected from tax costs. Thus, the withholding on pension distributions that are not rolled over in the "proper" way is entirely inappropriate. It is more a trap for the unwary than representative of valid fiscal policy. Where liberalization of the rollover rules serves as a vehicle to increase the distributions subject to withholding, this liberalization is not a benefit but a burden. Rather than fostering retirement savings, it enables the government to increase revenue potential at the expense of retirement savings. There are better sources of revenue, and even liberalization of the rollover rules could have been financed in a better way.

Rep. Jan Meyers).

143. See Notice Rules for Direct Rollovers Should be Modified, Commenters Suggest, *Pens. & Benefits Daily* (BNA) (Jan. 8, 1993) available in LEXIS, Fedtax library, BNAPEN file.

144. See *supra* note 121.

145. The IRS might also have been concerned that taxpayers were using the sixty-day period prior to rolling over the funds to apply the money to other uses. This in and of itself does not seem to justify requiring a taxpayer to elect a direct transfer or face a twenty percent withholding tax.

The area of pension plan administration is complicated enough without the addition of new compliance requirements. Strict notice provisions do not benefit plan participants in every case and do burden plan administrators in all cases. Furthermore, the more qualification requirements and other burdens that the Code imposes, the more deterrence there is to small companies who consider establishing qualified plans. Qualified plans foster the policy of encouraging employees to provide for their retirement, and although other concerns such as cost and equity must be considered, there is no need for further complication than what existed prior to the UCA. Under current law, cost and equity are comprehensively addressed. Simplicity is not so well addressed, and if any reforms should be made, they must be made in the name of simplification. The imposition of additional qualification requirements and notice provisions does not further this goal.

Although the UCA pension provisions should help the government collect tax due and owing on lump sum distributions from pension plans, the effects of the new rules illustrate the result of rushing a bill to passage for political reasons without adequately considering its ramifications. This is particularly dangerous in the pension area, where the law is already complicated. Other ramifications include the burdening of a particular group of people, that is, retirees, who are less likely to have financial options than actively employed individuals. The problems should be rectified by a repeal of the mandatory twenty percent withholding tax and the additional plan qualification requirement. Although this may cause some difficulties in transition, the end result will be worthwhile.

